Southwestern Bell Corporation

April 1, 1994

Ex Parte

William A. Blase, Jr.
Director
Federal Regulatory

Mr. William F. Caton
Acting Secretary
Federal Communications Commission
1919 M Street, N.W., Room 222
Washington, D.C. 20554

Re: RM No. 8388, Inquiry into Policies and Programs to Assure Universal Telephone Service in a Competitive Market Environment

Dear Mr. Caton:

In accordance with Commission rules governing ex parte presentations, attached is a written ex parte from Southwestern Bell Telephone Company addressing issues raised by MCI in an ex parte filing dated February 8, 1994, in this proceeding.

If you have any questions, please let me know.

Sincerely,

William A. Blase, Jr.

Attachment

cc: Richard Metzger
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THE DOWNSIDE OF
MCI's BASIC UNIVERSAL SERVICE PROPOSAL

As might be expected, because it is a purchaser of access, MCI is quick to criticize the level of LEC costs incurred to provide universal service even though its paper does not contain any support that shows how MCI's proposal will maintain or improve universal service. Similarly, MCI's voucher proposal is a thinly-veiled attempt to benefit MCI financially, likely at the expense of a ubiquitously available network constructed by the LECs which provides universal service.

Irrespective of MCI's unfounded allegations about the impropriety of LEC costs to provide universal service, SWBT strongly believes that it should have the ability to recover the costs it has and continues to incur to build and maintain a network that provides ubiquitously available universal service. SWBT supports the following basic approach for recovery of universal service costs in the competitive marketplace:

- LECs should be allowed rate rebalancing and pricing flexibility;
- If pricing flexibility is limited, other means should be allowed for LECs to recover costs associated with universal service from all users of the public switched network;
- Subsequent to rate rebalancing, additional explicit mechanisms should be targeted to end users who cannot afford basic telephone service;
- Existing explicit mechanisms (USF, LTS, Lifeline, Linkup, etc.) should continue to be maintained.

De-linking LEC Revenue from Universal Service

MCI claims that the support for universal service should be "de-linked" from LEC revenue requirements and replaced with a system that would ensure equal access to the universal service subsidy. MCI alleges that the $20B estimate of support for universal service is vastly overstated by LECs. Apparently, MCI does not understand that the $20B provides support to maintain a universal service network to low volume, high cost (largely rural) areas, and to keep basic local service rates low.

MCI's proposal is based on the premise that competitive providers should have access to LECs' universal service subsidies to help pay for deployment of their new networks even-though MCI has made no commitment to provide service to all customers, particularly those in high cost areas. Presumably, MCI's network would parallel existing LEC networks across the U.S.A. in order to bring choice to customers. While giving customers a choice is a noble notion supported by all, facilitating this choice through duplicate networks paid for with LEC subsidies creates a number of problems. First, the existing implicit subsidies were designed to recover the costs of the

ubiquitously deployed infrastructure. Therefore, MCI appears to suggest that either the existing network would have to be abandoned or two parallel networks would have to be subsidized. Neither one of these choices results in specific customer benefits.

Second, MCI' s paper is silent regarding commitments to provide universal service. Competitors are strangely quiet about making a firm commitment to provide a universally available ubiquitous network themselves. There is no evidence that MCI, MFS, or other potential local service providers intend to make the commitments necessary to satisfy universal service objectives. Consequently, voucher systems such as those proposed in MCI's paper make no sense and will only serve to further the real objective of MCI and other competitors which is to financially benefit by forcing LEC access rates down and/or by receiving vouchers for subsidies they don't need. Based on their actions so far and announced future actions, it is apparent that MCI, MFS and others intend to serve businesses located in metro areas. It is quite likely that MCI and other competitors will not put forth funds to place investments to provide service to residential customers and rural areas in the near future. Additionally, there is no indication they will commit the capital resources necessary to provide a ubiquitous public network. Thus far, the new local service providers are short on commitments to help maintain universal service, but are very focused on trying to get favorable regulatory treatment that will allow them to grab "subsidies" on a selective basis to help finance their entry into the local exchange business. In sum, MCI and others are focused solely on reducing their cost of access and/or gaining a financial or competitive advantage, not the provision or maintenance of universal service.

Even if MCI committed to provide universal service in selected areas, the LECs would most likely be left with the carrier of last resort (COLR) responsibilities. This would continue to obligate LECs to provide facilities and incur costs to serve all areas. Moreover, LECs will most likely not have the choice to exit a particular area they serve, whereas MCI will have the option to deny serving areas which it identifies as not beneficial to MCI. Thus, it appears that the LECs may have to continue to serve as the carrier of last resort.

In its paper, MCI makes several false and unsupported allegations regarding LEC operations and costs. MCI suggests that LEC cost recovery used to provide for universal service is an over-inflated number and really reflects the cost of their inefficient monopoly operations. It should be noted that LECs are to a great extent driven by the carrier of last resort obligations they have committed to in each and every state in which they operate. For example in Missouri, SWBT is a carrier of last resort by statute, in its territory. This means that SWBT has to have networks deployed and be ready to serve all customers in all locations, at all times, regardless of current demand. Further, the "readiness-to-serve" requirement extends far beyond the physical network and reaches to a number of operations such as availability of operator services, time limits on new installations, repairs, etc. Therefore, although

transparent to observers such as MCI, these COLR requirements create costs for the LECs. In addition, the regulatory agencies have consistently recognized SWBT costs necessary for readiness-to-serve capabilities, as legitimate and appropriate for recovery.

Further, MCI's allegations about the inefficiency in LECs' operations merely rely on a worn-out argument that LEC costs exceed "economic costs". MCI's use of the term "economic costs" is not only pejorative, it is simply wrong. MCI implies that the sum of the marginal or incremental costs of a firm represent all of the economic costs of the firm; this is incorrect. Any firm, especially a firm investing in a ubiquitous network to serve all customers on a timely basis, has economic costs that are fixed and joint and common. While economic/incremental cost studies are useful for making certain business decisions, they will fall short of being able to identify all LEC costs that are pertinent to providing a ubiquitous telephone network. Again the majority of the LECs' costs are fixed costs that are common to most services provided on the public network. Therefore, an economic/incremental cost analysis is not accurate for analyzing such costs. In fact, an economic cost study intentionally excludes non-directly attributable joint and common costs (because these are indivisible costs that cannot be unambiguously assigned to any particular service,) which is precisely why MCI is so focused on its use to analyze the problem. By equating the price for LEC services to economic cost, MCI could conveniently avoid paying for the costs necessary for providing the network.

MCI states that "today, by virtue of their internal subsidy, the individual LEC possesses a huge advantage over any potential competitor vying for the same customers." A primary creator of internal subsidies is rate averaging and contrary to MCI's assertion quite the opposite is true. The current regulatory structure has handicapped LECs by strictly controlling LEC prices. Price averaging has caused LEC prices to be artificially high in higher volume, low cost areas. A competitor is not constrained to average pricing and can often easily charge a price lower than the LECs. Further, competitors can pick and choose which customers they want to serve. This enables them to serve customers and areas that will provide the highest profit margins.

MCI unfairly assesses that LECs have profited the most from universal service funding and would like to see the system continue. Everyone, including MCI has profited from universal service. For instance, were it not for the ubiquitous network, Interexchange Carriers and others could not efficiently provide their services to all customers. Further, it is the LECs' profit levels and not the competitors' profit levels, that have been and are currently restricted by regulation.

I. Basic Universal Service

A. Defining the Service

MCI proposes that Basic Universal Service would provide residential local exchange service at rates no higher than the existing nationwide average of approximately $18 per month. MCI's definition of services to be included in basic universal service appears reasonable. However, there does not appear to be a compelling reason why rates for the basic service should be no greater than the nationwide average. Local service rates should reflect levels that are commensurate with the level of cost to serve the customer. It is not necessary that everyone, nationwide, pay no more than $18 per month. Those who can afford to pay for higher local service costs should pay those cost. If these higher rates are unaffordable for low income consumers, targeted subsidies (lifeline) should be provided.

B. Determining the Amount of the Required Subsidy

MCI states that under their proposal, the cost of performing specific network functions would be identified and quantified using an economic model that accounts for each function and recognizes the variables that affect cost, like population density. MCI further states, local phone companies already conduct similar cost analysis without undue hardship.

With this proposal, MCI makes yet another attempt to "sell" its building-block cost approach. As noted in the paper "USTA Position on Building Block Approach," building block costs are unrealistic and have a variety of shortcomings.

Further, MCI's definition of subsidy is narrow. Confining the universal service funding to local service is insufficient. Universal service not only requires that households and businesses be equipped with facilities to provide access to the local network, but also a network that provides ubiquitous connectivity between all subscribers. Providing this connectivity requires substantial investments in facilities necessary to transmit calls beyond local calling areas. Any universal service subsidy calculation must take these costs into account.

C. Generating Funding in a "Competitively Neutral" Way

SWBT agrees with MCI that universal service should be funded on an "equitable and competitively neutral basis." The proposal made by MCI is, however, a far cry from being equitable and competitively neutral.

MCI proposes that each carrier would contribute a percentage of its total telecommunications transmission and switching revenue, minus any payments to other carriers. MCI's plan essentially requires all telecommunications providers to contribute, including the LECs. This proposal will impose a double burden on the

LECs: first, LECs will incur costs for facilities and employees necessary for meeting universal service, COLR and readiness-to-serve requirements; and second, they will have to pay for a portion of their own and other local exchange providers' universal service costs. This is unfair in that LEC competitors are not required to incur facility or operational costs to provide universal service. They are more likely to rely on the existing LEC networks for ubiquitous transmission capability and for provision of telecommunications services to less efficient areas. Quite obviously, in the guise of a "reasonable proposal," MCI has advanced a proposal to benefit its bottom line and competitive position. The downside of this trojan horse proposal is that it would impose an extreme competitive disadvantage on the LECs, since, they would incur facility and operational costs that their competitor does not incur, and would have to raise rates substantially to fund the added costs associated with their universal service payment amount. This, in the end, would likely jeopardize not enhance universal service. A more equitable mechanism would exempt ubiquitous network providers (LECs) from funding requirements.

D. Distributing Funding in a "Provider Neutral" Way

MCI claims that once effective local competition is achieved, current monopoly providers will have to share subsidy benefits with new competitors. MCI proposes the use of virtual vouchers supplied to end users for end users to select which local exchange provider should receive the subsidy.

SWBT believes that this is a self-serving and inappropriate mechanism to selectively siphon subsidy amounts to MCI's bottom line. In fact, this voucher system is a disguised means to do just that. The revenues obtained by the support mechanisms such as rate averaging, CCL, etc., are necessary to maintain the ubiquitously available network which is used to provide universal service. Replacing the implicit subsidies in SWBT's rates with vouchers which could flow to MCI and others will allow SWBT's competitors to recover costs incurred by SWBT and will not allow SWBT to continue its carrier of last resort commitment to the ubiquitous network. Consequently, universal service will be jeopardized if this proposal was implemented.

E. Regulating the Transition to Effective Local Competition

MCI claims that it will take several years before the local exchange achieves true viable competition. However, continued strict regulatory oversight is not necessary for effective competition to flourish. In fact, continued regulation of LECs may stifle effective competition. For instance, MCI is concerned that it cannot compete assuming current LEC price levels that include subsidies. However, if LEC prices are rebalanced to remove the impacts of subsidy amounts, a much more competitive marketplace will develop. Also, for effective competition to exist, LECs should be allowed non-discriminatory access to competitive service providers' networks, which was not mentioned by MCI.

F. Fulfilling Carrier Responsibility: Consumer Safety Net

The fact that MCI finds a need for a consumer "safety net" in its proposed universal service plan suggests that MCI's proposal contains frailties that do not currently exist. Simply, a consumer "safety net" as proposed by MCI is not needed to assure universal service today.

MCI suggests that under its proposal customers would be able to choose the type of service and specific provider to receive their universal service subsidy. Unfortunately, a problem with this approach is that it over-simplifies the situation and does not address the issue of varying costs between urban and rural areas. According to MCI's example, customer A could select MCI to provide its service. What MCI apparently doesn't understand or chooses not to discuss is what would happen if the actual cost of providing service to customer A is $1,000 instead of the averaged rate of $25 estimated in the plan? Since the plan allows for the customer to be billed $18, and the remainder of $7 be recovered in subsidies, then apparently MCI would be willing to spend $975 out of pocket to provide service to customer A. SWBT expects that this high cost, likely rural but possibly urban, customer is not the customer that MCI would want to serve and when they realize the cost involved they would call for a LEC to provide service to customer A.

By focusing on average costs and rates, MCI's tentative proposal for distributing universal service subsidy payments could also encourage inefficient entry into local exchange markets. If, as MCI's example assumes, the average LEC cost to provide basic local service is $25, then by definition the actual cost to serve some customers is lower than $25. Suppose it costs LECs only $20 per customer to provide local service in densely populated urban centers. The LEC rate of $18 plus the subsidy of $7 implies that the LEC would be compensated in excess of its cost to provide service in urban areas. However, this will simply offset the losses that LECs incur in providing local exchange service in sparsely populated rural areas where the actual cost exceeds $25 per subscriber. If a new entrant begins providing local exchange service in an urban area served by a LEC, the entrant's price can be less than the LEC's $18 rate even if the entrant's cost is higher than the LEC's. Suppose it costs the new entrant $23 per subscriber to provide service. This is $3 higher than the LEC's actual urban area cost of $20. However, with the $7 subsidy, the new entrant's price can be as low as $16, or $2 lower than the average LEC rate of $18. Thus, requiring LECs to maintain average local service rates and using average LEC cost per subscriber to calculate subsidy amounts can lead to firms profitably entering urban (i.e., low cost) market segments even though their costs are higher than the incumbent LEC's.

Under MCI's plan, carriers other than LECs, will have a choice to-serve or not-to-serve particular areas. MCI suggests an "auction feature" similar to the Teleport proposal. It would be used if a carrier refuses to serve an area with the subsidy provided under the Basic Universal Service plan. In this circumstance, "carriers would 'bid' the level of per-line subsidy at which they are willing to serve the entire customer base within

the local exchange." However, this approach is also problematic. For example, a carriers' refusal to serve a market could mean that universal service may not exist for the customers in that market as it does today where service is provided by LECs. MCI's solution of auctioning off these areas does not address the possibility that for some areas there may be no bidders.

II. Advanced Universal Service

MCI's Advanced Universal Service addresses the availability of the emerging technologies and the anticipated cost associated with technological development and delivery. MCI is correct in saying that "it would be imprudent to impose a large subsidy burden to ensure widespread delivery of such services in the immediate future which would increase rates for all customers." However, MCI's proposal for an investment tax credit has a narrow focus and does not address the fact that pricing flexibility is also needed.

SWBT, first and foremost believes that the primary method to achieving Advanced Universal Service is to let consumers, through a competitive marketplace, determine the technologies and services to be deployed to best meet their needs. However, if regulators determine that advanced universal services should be available to areas that would not be served under market driven conditions, i.e., low density, high cost areas, then further development will be needed to address key issues such as (1) which technologies will best suit customer needs; (2) would consumers need or want digital technology; (3) will there be sufficient demand to defray the cost of some technologies; (4) how would the cost of such advanced ubiquitous networks be recovered; and (5) whether the creation of yet another "voucher system" is the answer?